

§ 1.1503-2 Dual consolidated loss.

(a) *Purpose and scope.* This section provides rules for the application of section 1503(d), concerning the determination and use of dual consolidated losses. Paragraph (b) of this section provides a general rule prohibiting a dual consolidated loss from offsetting the taxable income of a domestic affiliate. Paragraph (c) of this section provides definitions of the terms used in this section. Paragraph (d) of this section provides rules for calculating the amount of a dual consolidated loss and for adjusting the basis of stock of a dual resident corporation. Paragraph (e) of this section contains an anti-avoidance provision. Paragraph (f) of this section applies the rules of paragraph (d) of this section to the computation of foreign tax credit limitations. Paragraph (g) of this section provides certain exceptions to the limitation rule of paragraph (b) of this section. Finally, paragraph (h) of this section provides the effective date of the regulations and a provision for the retroactive application of the regulations to qualifying taxpayers.

(b) *In general—(1) Limitation on the use of a dual consolidated loss to offset income of a domestic affiliate.* Except as otherwise provided in this section, a dual consolidated loss of a dual resident corporation cannot offset the taxable income of any domestic affiliate in the taxable year in which the loss is recognized or in any other taxable year, regardless of whether the loss offsets income of another person under the income tax laws of a foreign country and regardless of whether the income that the loss may offset in the foreign country is, has been, or will be subject to tax in the United States. Pursuant to paragraph (c) (1) and (2) of this section, the same limitation shall apply to a dual consolidated loss of a separate unit of a domestic corporation as if the separate unit were a wholly owned subsidiary of such corporation.

(2) *Limitation on the use of a dual consolidated loss to offset income of a successor-in-interest.* A dual consolidated loss of a dual resident corporation also cannot be used to offset the taxable income of another corporation by means of a transaction in which the other corporation succeeds to the tax attributes

of the dual resident corporation under section 381 of the Code. Similarly, a dual consolidated loss of a separate unit of a domestic corporation cannot be used to offset income of the domestic corporation following the termination, liquidation, sale, or other disposition of the separate unit. However, if a dual resident corporation transfers its assets to another corporation in a transaction subject to section 381, and the acquiring corporation is a dual resident corporation of the same foreign country of which the transferor dual resident corporation is a resident, or a domestic corporation that carries on the business activities of the transferor dual resident corporation as a separate unit, then income generated by the transferee dual resident corporation, or separate unit, may be offset by the carryover losses of the transferor dual resident corporation. In addition, if a domestic corporation transfers a separate unit to another domestic corporation in a transaction subject to section 381, the income generated by the separate unit following the transfer may be offset by the carryover losses of the separate unit.

(3) *Application of rules to multiple tiers of separate units.* If a separate unit of a domestic corporation is owned indirectly through another separate unit, the principles of paragraph (b) (1) and (2) of this section shall apply as if the upper-tier separate unit were a subsidiary of the domestic corporation and the lower-tier separate unit were a lower-tier subsidiary.

(4) *Examples.* The following examples illustrate the application of this paragraph (b).

EXAMPLE 1. P, a domestic corporation, owns all of the outstanding stock of DRC, a domestic corporation. P and DRC file a consolidated U.S. income tax return. DRC is managed and controlled in Country W, a country that determines the tax residence of corporations according to their place of management and control. Therefore, DRC is a dual resident corporation and any net operating loss it incurs is a dual consolidated loss. In Years 1 through 3, DRC incurs dual consolidated losses. Under this paragraph (b), the dual consolidated losses may not be used to offset P's income on the group's consolidated U.S. income tax return. At the end of Year 3, DRC sells all of its assets and discontinues its business operations. DRC is

then liquidated into P, pursuant to the provisions of section 332. Normally, under section 381, P would succeed to, and be permitted to utilize, DRC's net operating loss carryovers. However, this paragraph (b) prohibits the dual consolidated losses of DRC from reducing P's income for U.S. tax purposes. Therefore, DRC's net operating loss carryovers will not be available to offset P's income.

EXAMPLE 2. The facts are the same as in *Example 1*, except that DRC does not sell its assets and, following the liquidation of DRC, P continues to operate DRC's business as a separate unit (e.g., a branch). DRC's loss carryovers are available to offset P's income generated by the assets previously owned by DRC and now held by the separate unit.

(c) *Definitions.* The following definitions shall apply for purposes of this section.

(1) *Domestic corporation.* The term "domestic corporation" has the meaning assigned to it by section 7701(a) (3) and (4). The term also includes any corporation otherwise treated as a domestic corporation by the Code, including, but not limited to, sections 269B, 953(d), and 1504 (d). For purposes of this section, any separate unit of a domestic corporation, as defined in paragraph (c) (3) and (4) of this section, shall be treated as a separate domestic corporation.

(2) *Dual resident corporation.* A dual resident corporation is a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis. A corporation is taxed on a residence basis if it is taxed as a resident under the laws of the foreign country. An S corporation, as defined in section 1361, is not a dual resident corporation. For purposes of this section, any separate unit of a domestic corporation, as defined in paragraph (c) (3) and (4) of this section, shall be treated as a dual resident corporation. Unless otherwise indicated, any reference in this section to a dual resident corporation refers also to a separate unit.

(3) *Separate unit*—(i) The term "separate unit" shall mean any of the following:

(A) A foreign branch, as defined in § 1.367(a)-6T(g) (or a successor regulation), that is owned either directly by a domestic corporation or indirectly by a domestic corporation through ownership of a partnership or trust interest

(regardless of whether the partnership or trust is a United States person);

(B) an interest in a partnership; or

(C) an interest in a trust.

(ii) If two or more foreign branches located in the same foreign country are owned by a single domestic corporation and the losses of each branch are made available to offset the income of the other branches under the tax laws of the foreign country, within the meaning of paragraph (c)(15)(ii) of this section, then the branches shall be treated as one separate unit.

(4) *Hybrid entity separate unit.* The term "separate unit" includes an interest in an entity that is not taxable as an association for U.S. income tax purposes but is subject to income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis.

(5) *Dual consolidated loss*—(i) *In general.* The term "dual consolidated loss" means the net operating loss (as defined in section 172(c) and the regulations thereunder) of a domestic corporation incurred in a year in which the corporation is dual resident corporation. The dual consolidated loss shall be computed under paragraph (d)(1) of this section. The fact that a particular item taken into account in computing a dual resident corporation's net operating loss is not taken into account in computing income subject to a foreign country's income tax shall not cause such item to be excluded from the calculation of the dual consolidated loss.

(ii) *Exceptions.* A dual consolidated loss shall not include the following—

(A) A net operating loss incurred by a dual resident corporation in a foreign country whose income tax laws—

(1) Do not permit the dual resident corporation to use its losses, expenses or deductions to offset the income of any other person that is recognized in the same taxable year in which the losses, expenses or deductions are incurred; and

(2) Do not permit the losses, expenses or deductions of the dual resident corporation to be carried over or back to be used, by any means, to offset the income of any other person in other taxable years; or

(B) A net operating loss incurred during that portion of the taxable year prior to the date on which the domestic corporation becomes a dual resident corporation or subsequent to the date on which the domestic corporation ceases to be a dual resident corporation. For purposes of determining the amount of the net operating loss incurred in that portion of the taxable year prior to the date on which the domestic corporation becomes a dual resident corporation or subsequent to the date on which the domestic corporation ceases to be a dual resident corporation, in no event shall more than the aggregate of the equal daily portion of the net operating loss commensurate with the portion of the taxable year during which the domestic corporation was not a dual resident corporation be allocated to that portion of the taxable year in which the domestic corporation was not a dual resident corporation.

(iii) *Dual consolidated losses of separate units that are partnership interests, including interests in hybrid entities.* [Reserved]

(6) *Subject to tax.* For purposes of determining whether a domestic corporation is subject to the income tax of a foreign country on its income, the fact that the corporation has no actual income tax liability to the foreign country for a particular taxable year shall not be taken into account.

(7) *Foreign country.* For purposes of this section, possessions of the United States shall be considered foreign countries.

(8) *Consolidated group.* The term “consolidated group” means an affiliated group, as defined in section 1504(a), with which a dual resident corporation or domestic owner files a consolidated U.S. income tax return.

(9) *Domestic owner.* The term “domestic owner” means a domestic corporation that owns one or more separate units.

(10) *Affiliated dual resident corporation or affiliated domestic owner.* The term “affiliated dual resident corporation” or “affiliated domestic owner” means a dual resident corporation or domestic owner that is a member of a consolidated group.

(11) *Unaffiliated dual resident corporation or unaffiliated domestic owner.* The term “unaffiliated dual resident corporation” or “unaffiliated domestic owner” means a dual resident corporation or domestic owner that is an unaffiliated domestic corporation.

(12) *Successor-in-interest.* The term “successor-in-interest” means an acquiring corporation that succeeds to the tax attributes of an acquired corporation by means of a transaction subject to section 381.

(13) *Domestic affiliate.* The term “domestic affiliate” means any member of an affiliated group, without regard to the exceptions contained in section 1504(b) (other than section 1504(b)(3)) relating to includible corporations.

(14) *Unaffiliated domestic corporation.* The term “unaffiliated domestic corporation” means a domestic corporation that is not a member of an affiliated group.

(15) *Use of loss to offset income of a domestic affiliate or another person—*(i) A dual consolidated loss shall be deemed to offset income of a domestic affiliate in the year it is included in the computation of the consolidated taxable income of a consolidated group. The fact that no tax benefit results from the inclusion of the dual consolidated loss in the computation of the group’s consolidated taxable income in the taxable year shall not be taken into account.

(ii) Except as provided in paragraph (c)(15)(iii) of this section, a loss, expense, or deduction taken into account in computing a dual consolidated loss shall be deemed to offset income of another person under the income tax laws of a foreign country in the year it is made available for such offset. The fact that the other person does not have sufficient income in that year to benefit from such an offset shall not be taken into account. However, where the laws of a foreign country provide an election that would enable a dual resident corporation or separate unit to use its losses, expenses, or deductions to offset income of another person, the losses, expenses, or deductions shall be considered to offset such income only if the election is made.

(iii) The losses, expenses, or deductions taken into account in computing

a dual resident corporation's or separate unit's dual consolidated loss shall not be deemed to offset income of another person under the income tax laws of a foreign country for purposes of this section, if under the laws of the foreign country the losses, expenses, or deductions of the dual resident corporation or separate unit are used to offset the income of another dual resident corporation or separate unit within the same consolidated group (or income of another separate unit that is owned by the unaffiliated domestic owner of the first separate unit). If the losses, expenses, or deductions of a dual resident corporation or separate unit are made available under the laws of a foreign country to offset the income of other dual resident corporations or separate units within the same consolidated group (or other separate units owned by the unaffiliated domestic owner of the first separate unit), as well as the income of another person, and the laws of the foreign country do not provide applicable rules for determining which person's income is offset by the losses, expenses, or deductions, then for purposes of this section, the losses, expenses or deductions shall be deemed to offset the income of the other dual resident corporations or separate units, to the extent of such income, before being considered to offset the income of the other person.

(iv) Except to the extent paragraph (g)(1) of this section applies, where the income tax laws of a foreign country deny the use of losses, expenses, or deductions of a dual resident corporation to offset the income of another person because the dual resident corporation is also subject to income taxation by another country on its worldwide income or on a residence basis, the dual resident corporation shall be treated as if it actually had offset its dual consolidated loss against the income of another person in such foreign country.

(16) *Examples.* The following examples illustrate this paragraph (c).

EXAMPLE 1. X, a member of a consolidated group, conducts business through a branch in Country Y. Under Country Y's income tax laws, the branch is taxed as a permanent establishment and its losses may be used under the Country Y form of consolidation to offset the income of Z, a Country Y affiliate of X. In Year 1, the branch of X incurs an overall

loss that would be treated as a net operating loss if the branch were a separate domestic corporation. Under paragraph (c)(3) of this section, the branch of X is treated as a separate domestic corporation and a dual resident corporation. Thus, under paragraph (c)(5), its loss constitutes a dual consolidated loss. Unless X qualifies for an exception under paragraph (g) of this section, paragraph (b) of this section precludes the use of the branch's loss to offset any income of X not derived from the branch operations or any income of a domestic affiliate of X.

EXAMPLE 2. A and B are members of a consolidated group. FC is a Country X corporation that is wholly owned by B. A and B organize a partnership, P, under the laws of Country X. P conducts business in Country X and its business activity constitutes a foreign branch within the meaning of paragraph (c)(3)(i)(A) of this section. P also earns U.S. source income that is unconnected with the branch operations and, therefore, is not subject to tax by Country X. Under the laws of Country X, the branch can consolidate with FC. The interests in P held by A and B are each treated as a dual resident corporation. The branch is also treated as a separate dual resident corporation. Unless an exception under paragraph (g) of this section applies, any dual consolidated loss incurred by P's branch cannot offset the U.S. source income earned by P or any other income of A or B.

EXAMPLE 3. X is classified as a partnership for U.S. income tax purposes. A, B, and C are the sole partners of X. A and B are domestic corporations and C is a Country Y corporation. For U.S. income tax purposes, each partner has an equal interest in each item of partnership profit or loss. Under Country Y's law, X is classified as a corporation and its income and losses may be used under the Country Y form of consolidation to offset the income of companies that are affiliates of X. Under paragraph (c)(3) and (4) of this section, the partnership interests held by A and B are treated as separate domestic corporations and as dual resident corporations. Unless an exception under paragraph (g) of this section applies, losses allocated to A and B can only be used to offset profits of X allocated to A and B, respectively.

EXAMPLE 4. P, a domestic corporation, files a consolidated U.S. income tax return with its two wholly-owned domestic subsidiaries, DRC1 and DRC2. Each subsidiary is also treated as a Country Y resident for Country Y tax purposes. Thus, DRC1 and DRC2 are dual resident corporations. DRC1 owns FC, a Country Y corporation. Country Y's tax laws permit affiliated resident corporations to file a form of consolidated return. In Year 1, DRC1 incurs a \$200 net operating loss for both U.S. and Country Y tax purposes, while DRC2 recognizes \$200 of income under the tax laws of each country. FC also earns \$200 of income for Country Y tax purposes. DRC1,

DRC2, and FC file a Country Y consolidated return. However, Country Y has no applicable rules for determining which income is offset by DRC1's \$200 loss. Under paragraph (c)(15)(iii) of this section, the loss shall be treated as offsetting DRC2's \$200 of income. Because DRC1 and DRC2 are members of the same consolidated group, for purposes of this section, the offset of DRC1's loss against the income of DRC2 is not considered a use of the loss against the income of another person under the laws of a foreign country.

EXAMPLE 5. DRC, a domestic corporation, files a consolidated U.S. income tax return with its parent, P. DRC is also subject to tax in Country Y on its worldwide income. Therefore, DRC is a dual resident corporation and any net operating loss incurred by DRC is a dual consolidated loss. Country Y's tax laws permit corporations that are subject to tax on their worldwide income to use the Country Y form of consolidation, thus enabling eligible corporations to use their losses to offset income of affiliates. However, to prevent corporations like DRC from offsetting losses against income of affiliates in Country Y and then again offsetting the losses against income of foreign affiliates under the tax laws of another country, Country Y prevents a corporation that is also subject to the income tax of another country on its worldwide income or on a residence basis from using the Country Y form of consolidation. There is no agreement, as described in paragraph (g)(1) of this section, between the United States and Country Y. Because of Country Y's statute, DRC will be treated as having actually offset its losses against the income of affiliates in Country Y under paragraph (c)(15)(iv) of this section. Therefore, DRC will not be able to file an agreement described in paragraph (g)(2) of this section and offset its losses against the income of P or any other domestic affiliate.

(d) *Special rules for accounting for dual consolidated losses*—(1) *Determination of amount of dual consolidated loss*—(i) *Dual resident corporation that is a member of a consolidated group.* For purposes of determining whether a dual resident corporation that is a member of a consolidated group has a dual consolidated loss for the taxable year, the dual resident corporation shall compute its taxable income (or loss) in accordance with the rules set forth in the regulations under section 1502 governing the computation of consolidated taxable income, taking into account only the dual resident corporation's items of income, gain, deduction, and loss for the year. However, for purposes of this computation, the following items shall not be taken into account:

(A) Any net capital loss of the dual resident corporation; and

(B) Any carryover or carryback losses.

(ii) *Dual resident corporation that is a separate unit of a domestic corporation.* For purposes of determining whether a separate unit has a dual consolidated loss for the taxable year, the separate unit shall compute its taxable income (or loss) as if it were a separate domestic corporation and a dual resident corporation in accordance with the provisions of paragraph (d)(1)(i) of this section, using only those items of income, expense, deduction, and loss that are otherwise attributable to such separate unit.

(2) *Effect of a dual consolidated loss.* For any taxable year in which a dual resident corporation or separate unit has a dual consolidated loss to which paragraph (b) of this section applies, the following rules shall apply.

(i) If the dual resident corporation is a member of a consolidated group, the group shall compute its consolidated taxable income without taking into account the items of income, loss, or deduction taken into account in computing the dual consolidated loss. The dual consolidated loss may be carried over or back for use in other taxable years as a separate net operating loss carryover or carryback of the dual resident corporation arising in the year incurred. It shall be treated as a loss incurred by the dual resident corporation in a separate return limitation year and (without regard to whether the dual resident corporation is a common parent) shall be subject to all of the limitations of §§1.1502-21A(c) or 1.1502-21(c), as appropriate (relating to limitations on net operating loss carryovers and carrybacks from separate return limitation years).

(ii) The unaffiliated domestic owner of a separate unit, or the consolidated group of an affiliated domestic owner, shall compute its taxable income without taking into account the items of income, loss or deduction taken into account in computing the separate unit's dual consolidated loss. The dual consolidated loss shall be treated as a loss incurred by a separate corporation and its use shall be subject to all of the limitations of §§1.1502-21A(c) or 1.1502-

21(c), as appropriate, as if the separate unit were filing a consolidated return with the unaffiliated domestic owner or with the consolidated group of the affiliated domestic owner.

(3) *Basis adjustments for dual consolidated losses*—(i) *Dual resident corporation that is a member of an affiliated group.* When a dual resident corporation is a member of a consolidated group, each other member owning stock in the dual resident corporation shall adjust the basis of the stock in the following manner.

(A) *Positive adjustments.* Positive adjustments shall be made in accordance with the principles of § 1.1502-32(b)(1), except that there shall be no positive adjustment under § 1.1502-32(b)(1)(ii) for any amount of the dual consolidated loss that is not absorbed as a result of the application of paragraph (b) of this section. In addition, there shall be no positive adjustment for any amount included in income pursuant to paragraph (g)(2)(vii) of this section.

(B) *Negative adjustments.* Negative adjustments shall be made in accordance with the principles of § 1.1502-32(b)(2), except that there shall be no negative adjustment under § 1.1502-32(b)(2)(ii) for the amount of the dual consolidated loss subject to paragraph (b) of this section that is absorbed in a carryover year.

(ii) *Dual resident corporation that is a separate unit arising from an interest in a partnership.* Where a separate unit is an interest in a partnership, the domestic owner shall adjust its basis in the separate unit in accordance with section 705, except that no increase in basis shall be permitted for any amount included as income pursuant to paragraph (g)(2)(vii) of this section.

(4) *Examples.* The following examples illustrate this paragraph (d).

EXAMPLE 1. (i) P, S1, S2, and T are domestic corporations. P owns all of the stock of S1 and S2. S2 owns all of the stock of T. T is a resident of Country FC for Country FC income tax purposes. Therefore, T is a dual resident corporation. P, S1, S2, and T file a consolidated U.S. income tax return. X and Y are corporations that are not members of the consolidated group.

(ii) At the beginning of Year 1, P has a basis of \$1000 in the stock of S2. S2 has a \$500 basis in the stock of T.

(iii) In Year 1, T incurs interest expense in the amount of \$100. In addition, T sells a noncapital asset, *u*, in which it has a basis of \$10, to S1 for \$50. T also sells a noncapital asset, *v*, in which it has a basis of \$200, to S1 for \$100. The sales of *u* and *v* are intercompany transactions described in § 1.1502-13. T also sells a capital asset, *z*, in which it has a basis of \$180, to Y for \$90. In Year 1, S1 earns \$200 of separate taxable income, calculated in accordance with § 1.1502-12, as well as \$90 of capital gain from a sale of an asset to X. P and S2 have no items of income, loss, or deduction for Year 1.

(iv) In Year 1, T has a dual consolidated loss of \$100 (attributable to its interest expense). T's \$90 capital loss is not included in the computation of the dual consolidated loss. Instead, T's capital loss is included in the computation of the consolidated group's capital gain net income under § 1.1502-22(c) and is used to offset S1's \$90 capital gain.

(v) No elective agreement, as described in paragraph (g)(1) of this section, exists between the United States and Country FC. For Country FC tax purposes, T's \$100 loss is offset against the income of a Country FC affiliate. Therefore, T is not eligible for the exception provided in paragraph (g)(2) of this section.

(vi) Because T has a dual consolidated loss for the year, the consolidated taxable income of the consolidated group is calculated without regard to T's items of income, loss or deduction taken into account in computing the dual consolidated loss. Therefore, the consolidated taxable income of the consolidated group is \$200 (the sum of \$200 of separate taxable income earned by S1 plus \$90 of capital gain earned by S1 minus \$90 of capital loss incurred by T). The \$40 gain recognized by T upon the sale of item *u* to S1 and the \$100 loss recognized by T upon the sale of item *v* to S1 are deferred pursuant to § 1.1502-13(c)(1).

(vii) S2 may not make the positive adjustment provided for in § 1.1502-32(b)(1)(ii) to its basis in the stock of T for the \$100 dual consolidated loss incurred by T. In addition, no positive adjustment in the basis of the stock is required for T's \$90 capital loss because the loss has been absorbed by the consolidated group. S2, however, must make the negative adjustment provided for in § 1.1502-32(b)(2)(i) for its allocable part of T's deficit in earnings and profits for the taxable year attributable to both T's \$100 dual consolidated loss and T's \$90 capital loss. Thus, as provided in § 1.1502-32(e)(1), S2 must make a \$190 net negative adjustment to its basis in the stock of T, reducing its basis to \$310. As provided in § 1.1502-33(c)(4)(ii)(a), S2's earnings and profits for Year 1 will reflect S2's decrease in its basis in T stock for the taxable year. Since S2 has no other earnings and profits for the taxable year, S2 has a \$190 deficit in earnings and profits for the year. As

provided in § 1.1502-32(b)(2)(i), P must make a negative adjustment to its basis in the stock of S2 for its allocable part of S2's deficit in earnings and profits for the taxable year. Thus, P must make a \$190 net negative adjustment to its basis in S2 stock, reducing its basis to \$810.

EXAMPLE 2. (i) The facts are the same as in Example 1, except that in Year 2, S1 sells items *u* and *v* to X for no gain or loss. The disposition of items *u* and *v* outside of the consolidated group restores the deferred loss and gain to T. T also incurs \$100 of interest expense in Year 2. In addition, T sells a non-capital asset, *r*, in which it has a basis of \$100, to Y for \$300. P and S2 have no items of income, loss, or deduction for Year 2.

(ii) T has \$40 of separate taxable income in Year 2, computed as follows:

(\$100)	interest expense
(\$100)	sale of item <i>v</i> to S1
\$ 40	sale of item <i>u</i> to S1
\$200	sale of item <i>r</i> to Y

\$ 40

Thus, T has no dual consolidated loss for the year.

(iii) Since T does not have a dual consolidated loss for the taxable year, the group's consolidated taxable income is calculated in accordance with the general rule of § 1.1502-11 and not in accordance with paragraph (d)(2) of this section. T is the only member of the consolidated group that has any income or loss for the taxable year. Thus, the consolidated taxable income of the group, computed without regard to T's dual consolidated loss carryover, is \$40.

(iv) As provided by § 1.1502-21A(c), the amount of the dual consolidated loss arising in Year 1 that is included in the group's consolidated net operating loss deduction for Year 2 is \$40 (that is, the consolidated taxable income computed without regard to the consolidated net operating loss deduction minus such consolidated taxable income recomputed by excluding the items of income and deduction of T). Thus, the group has no consolidated taxable income for the year.

(v) S2 must make the positive adjustment provided for in § 1.502-32(b)(1)(i) to its basis in T stock for its allocable part of T's undistributed earnings and profits for the taxable year. S2 cannot make the negative adjustment provided for in § 1.1502-32(b)(2)(ii) for the dual consolidated loss of T incurred in Year 1 and absorbed in Year 2. Thus, as provided in § 1.1502-32(e)(2), S2 must make a \$40 net positive adjustment to its basis in T stock, increasing its basis to \$350. As provided in § 1.1502-33(c)(4)(ii)(a), S2's earnings and profits for Year 2 will reflect S2's increase in its basis in T stock for the taxable year. Since S2 has no other earnings and profits for the taxable year, S2 has \$40 of earnings and profits for the year. As pro-

vided in § 1.1502-32(b)(1)(i), P must make a positive adjustment to its basis in the stock of S2 for its allocable part of the undistributed earnings and profits of S2 for the taxable year. Thus, P must make a \$40 net positive adjustment to its basis in S2 stock, increasing its basis to \$850.

(e) *Special rule for use of dual consolidated loss to offset tainted income*—(1) *In general.* The dual consolidated loss of any dual resident corporation that ceases to be a dual resident corporation shall not be used to offset income of such corporation to the extent that such income is tainted income, as defined in paragraph (e)(2) of this section.

(2) *Tainted income defined.* Tainted income is any income derived from tainted assets, as defined in paragraph (e)(3) of this section, beginning on the date such assets are acquired by the dual resident corporation. In the absence of evidence establishing the actual amount of income that is attributable to the tainted assets, the portion of a corporation's income in a particular taxable year that is treated as tainted income shall be an amount equal to the corporation's taxable income for the year multiplied by a fraction, the numerator of which is the fair market value of the tainted asset at the end of the taxable year and the denominator of which is the fair market value of the total assets owned by the corporation at the end of the taxable year. Documentation submitted to establish the actual amount of income that is attributable to the tainted assets must be attached to the consolidated group's or unaffiliated dual resident corporation's timely filed tax return for the taxable year in which the income is recognized.

(3) *Tainted assets defined.* Tainted assets are any asset acquired by a dual resident corporation in a non-recognition transaction, as defined in section 7701(a)(45), or any assets otherwise transferred to the corporation as a contribution to capital, at any time during the three taxable years immediately preceding the taxable year in which the corporation ceases to be a dual resident corporation or at any time thereafter. Tainted assets shall not include assets that were acquired by such dual resident corporation on or before December 31, 1986.

(4) *Exceptions.* Income derived from assets acquired by a dual resident corporation shall not be subject to the limitation described in paragraph (e)(1) of this section, if—

(i) For the taxable year in which the assets were acquired, the corporation did not have a dual consolidated loss (or a carry forward of a dual consolidated loss to such year); or

(ii) The assets were acquired as replacement property in the ordinary course of business.

(f) *Computation of foreign tax credit limitations.* If a dual resident corporation or separate unit is subject to paragraph (d)(2) of this section, the consolidated group or unaffiliated domestic owner shall compute its foreign tax credit limitation by applying the limitations of paragraph (d)(2). Thus, the dual consolidated loss is not taken into account until the year in which it is absorbed.

(g) *Exception—(1) Elective agreement in place between the United States and a foreign country.* Paragraph (b) of this section shall not apply to a dual consolidated loss to the extent the dual resident corporation, or domestic owner of a separate unit, elects to deduct the loss in the United States pursuant to an agreement entered into between the United States and a foreign country that puts into place an elective procedure through which losses offset income in only one country.

(2) *Elective relief provision—(i) In general.* Paragraph (b) of this section shall not apply to a dual consolidated loss if the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner elects to be bound by the provisions of this paragraph (g)(2). In order to elect relief under this paragraph (g)(2), the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must attach to its timely filed U.S. income tax return for the taxable year in which the dual consolidated loss is incurred an agreement described in this paragraph (g)(2)(i). The agreement must be signed under penalties of perjury by the person who signs the return and must include the following items, in paragraphs labeled to correspond with the items set forth below:

(A) A statement that the document submitted is an election and an agreement under the provisions of §1.1503-2(g)(2) of the Income Tax Regulations;

(B) The name, address, identifying number, and place and date of incorporation of the dual resident corporation, and the country or countries that tax the dual resident corporation on its worldwide income or on a residence basis, or, in the case of a separate unit, identification of the separate unit, including the name under which it conducts business, its principal activity, and the country in which its principal place of business is located;

(C) An agreement by the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner to comply with all of the provisions of paragraphs (g)(2) (iii) through (vii) of §1.1503-2;

(D) A statement of the amount of the dual consolidated loss covered by the agreement;

(E) A certification that no portion of the dual resident corporation's or separate unit's loss, expenses, or deductions taken into account in computing the dual consolidated loss has been, or will be, used to offset the income of any other person under the income tax laws of a foreign country; and

(F) A certification that arrangements have been made to ensure that no portion of the dual consolidated loss will be used to offset the income of another person under the laws of a foreign country and that the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner will be informed of any such foreign use of any portion of the dual consolidated loss.

(ii) *Consistency rule—(A)* If any loss, expense, or deduction taken into account in computing the dual consolidated loss of a dual resident corporation or separate unit is used under the laws of a foreign country to offset the income of another person, then the following other dual consolidated losses (if any) shall be treated as also having been used to offset income of another person under the laws of such foreign country, but only if the income tax laws of the foreign country permit any loss, expense, or deduction taken into account in computing the other dual

consolidated loss to be used to offset the income of another person in the same taxable year;

(1) Any dual consolidated loss of a dual resident corporation that is a member of the same consolidated group of which the first dual resident corporation or domestic owner is a member, if any loss, expense, or deduction taken into account in computing such dual consolidated loss is recognized under the income tax laws of such country in the same taxable year; and

(2) Any dual consolidated loss of a separate unit that is owned by the same domestic owner that owns the first separate unit, or that is owned by any member of the same consolidated group of which the first dual resident corporation or domestic owner is a member, if any loss, expense, or deduction taken into account in computing such dual consolidated loss is recognized under the income tax laws of such country in the same taxable year.

(B) The following examples illustrate the application of this paragraph (g)(2)(ii).

EXAMPLE 1. P, a domestic corporation, owns A and B, which are domestic corporations, and C, a Country X corporation. A is subject to the income tax laws of Country X on a residence basis and, thus, is a dual resident corporation. B conducts business in Country X through a branch, which is a separate unit under paragraph (c)(3) of this section. The income tax laws of Country X permit branches of foreign corporations to elect to file consolidated returns with Country X affiliates. In Year 1, A incurs a dual consolidated loss, which is used to offset the income of C under the Country X form of consolidation. The branch of B also incurs a net operating loss. However, B elects not to use the loss on a Country X consolidated return to offset the income of foreign affiliates. The use of A's loss to offset the income of C in Country X will cause the separate unit of B to be treated as if it too had used its dual consolidated loss to offset the income of an affiliate in Country X. Therefore, an election and agreement under this paragraph (g)(2) cannot be made with respect to the separate unit's dual consolidated loss.

EXAMPLE 2. The facts are the same as in Example 1, except that the income tax laws of Country X do not permit branches of foreign corporations to file consolidated income tax returns with Country X affiliates. Therefore, an election and agreement described in this paragraph (g)(2) may be made for the dual

consolidated loss incurred by the separate unit of B.

(iii) *Triggering events requiring the recapture of dual consolidated losses*—(A) The consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must agree that, if there is a triggering event described in this paragraph (g)(2)(iii), and no exception applies under paragraph (g)(2)(iv) of this section, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner will recapture and report as income the amount of the dual consolidated loss provided in paragraph (g)(2)(vii) of this section on its tax return for the taxable year in which the triggering event occurs (or, when the triggering event is a use of the loss for foreign purposes, the taxable year that includes the last day of the foreign tax year during which such use occurs). In addition, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must pay any applicable interest charge required by paragraph (g)(2)(vii) of this section. For purposes of this section, any of the following events shall constitute a triggering event:

(1) In any taxable year up to and including the 15th taxable year following the year in which the dual consolidated loss that is the subject of the agreement filed under this paragraph (g)(2) was incurred, any portion of the losses, expenses, or deductions taken into account in computing the dual consolidated loss is used by any means to offset the income of any other person under the income tax laws of a foreign country;

(2) An affiliated dual resident corporation or affiliated domestic owner ceases to be a member of the consolidated group that filed the election. For purposes of this paragraph (g)(2)(iii)(A)(2), a dual resident corporation or domestic owner shall be considered to cease to be a member of the consolidated group if it is no longer a member of the group within the meaning of § 1.1502-1(b), or if the group ceases to exist because the common parent is no longer in existence or is no longer a common parent or the group

no longer files on the basis of a consolidated return. Such disaffiliation, however, shall not constitute a triggering event if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the dual resident corporation's or separate unit's losses, expenses, or deductions cannot be used to offset income of another person under the laws of a foreign country at any time after the affiliated dual resident corporation or affiliated domestic owner ceases to be a member of the consolidated group;

(3) An unaffiliated dual resident corporation or unaffiliated domestic owner becomes a member of a consolidated group. Such affiliation of the dual resident corporation or domestic owner, however, shall not constitute a triggering event if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the losses, expenses, or deductions of the dual resident corporation or separate unit cannot be used to offset the income of another person under the laws of a foreign country at any time after the dual resident corporation or domestic owner becomes a member of the consolidated group.

(4) A dual resident corporation transfers assets in a transaction that results, under the laws of a foreign country, in a carryover of its losses, expenses, or deductions. For purposes of this paragraph (g)(2)(iii)(A)(4), a transfer, either in a single transaction or a series of transactions within a twelve-month period, of 50% or more of the dual resident corporation's assets (measured by the fair market value of the assets at the time of such transfer (or for multiple transactions, at the time of the first transfer)) shall be deemed a triggering event, unless the taxpayer demonstrates, to the satisfaction of the Commissioner, that the transfer of assets did not result in a carryover under foreign law of the dual resident corporation's losses, expenses, or deductions to the transferee of the assets;

(5) A domestic owner of a separate unit transfers assets of the separate unit in a transaction that results, under the laws of a foreign country, in a carryover of the separate unit's losses, expenses, or deductions. For purposes of this paragraph

(g)(2)(iii)(A)(5), a transfer, either in a single transaction or a series of transactions over a twelve-month period, of 50% or more of the separate unit's assets (measured by the fair market value of the assets at the time of the transfer (or for multiple transfers, at the time of the first transfer)), shall be deemed a triggering event, unless the taxpayer demonstrates, to the satisfaction of the Commissioner, that the transfer of assets did not result in a carryover under foreign law of the separate unit's losses, expenses, or deductions to the transferee of the assets;

(6) An unaffiliated dual resident corporation or unaffiliated domestic owner becomes a foreign corporation by means of a transaction (*e.g.*, a reorganization) that, for foreign tax purposes, is not treated as involving a transfer of assets (and carryover of losses) to a new entity. Such a transaction, however, shall not constitute a triggering event if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the dual resident corporation's or separate unit's losses, expenses, or deductions cannot be used to offset income of another person under the laws of the foreign country at any time after the unaffiliated dual resident corporation or unaffiliated domestic owner becomes a foreign corporation.

(7) A domestic owner of a separate unit, either in a single transaction or a series of transactions within a twelve-month period, sells, or otherwise disposes of, 50% or more of the interest in the separate unit (measured by voting power or value) owned by the domestic owner on the last day of the taxable year in which the dual consolidated loss was incurred. For purposes of this paragraph (g)(2)(iii)(A)(7), the domestic owner shall be deemed to have disposed of its entire interest in a hybrid entity separate unit if such hybrid entity becomes classified as a foreign corporation for U.S. tax purposes. The disposition of 50% or more of the interest in a separate unit, however, shall not constitute a triggering event if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the losses, expenses, or deductions of the separate unit cannot be used to offset income of another person under the laws of the

foreign country at any time after the disposition of the interest in the separate unit; or

(8) The consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner fails to file a certification required under paragraph (g)(2)(vi)(B) of this section.

(B) A taxpayer wishing to rebut the presumption of a triggering event described in paragraphs (g)(2)(iii)(A)(2) through (7) of this section, by demonstrating that the losses, expenses, or deductions of the dual resident corporation or separate unit cannot be carried over or otherwise used under the laws of the foreign country, must attach documents demonstrating such facts to its timely filed U.S. income tax return for the year in which the presumed triggering event occurs.

(C) The following example illustrates this paragraph (g)(2)(iii).

EXAMPLE. DRC, a domestic corporation, is a member of CG, a consolidated group. DRC is a resident Country Y for Country Y income tax purposes. Therefore, DRC is a dual resident corporation. In Year 1, DRC incurs a dual consolidated loss of \$100. CG files an agreement described in paragraph (g)(2) of this section and, thus, the \$100 dual consolidated loss is included in the computation of CG's consolidated taxable income. In Year 6, all of the stock of DRC is sold to P, a domestic corporation that is a member of NG, another consolidated group. The sale of DRC to P is a triggering event under paragraph (g)(2)(iii)(A) of this section, requiring the recapture of the dual consolidated loss. However, the laws of Country Y provide for a five-year carryover period for losses. At the time of DRC's disaffiliation from CG, the losses, expenses and deductions that were included in the computation of the dual consolidated loss had expired for Country Y purposes. Therefore, upon adequate documentation that the losses, expenses, or deductions have expired for Country Y purposes, CG can rebut the presumption that a triggering event has occurred.

(iv) *Exceptions*—(A) *Acquisition by a member of the consolidated group.* The following events shall not constitute triggering events, requiring the recapture of the dual consolidated loss under paragraph (g)(2)(vii) of this section:

(1) An affiliated dual resident corporation or affiliated domestic owner ceases to be a member of a consolidated group solely by reason of a transaction in which a member of the same

consolidated group succeeds to the tax attributes of the dual resident corporation or domestic owner under the provisions of section 381;

(2) Assets of an affiliated dual resident corporation or assets of a separate unit of an affiliated domestic owner are acquired by a member of its consolidated group in any other transaction; or

(3) An affiliated domestic owner of a separate unit transfers its interest in the separate unit to another member of its consolidated group.

(B) *Acquisition by an unaffiliated domestic corporation or a new consolidated group*—(1) If the requirements of paragraph (g)(2)(iv)(B)(2) of this section are met, the following events shall not constitute triggering events, requiring the recapture of the dual consolidated loss under paragraph (g)(2)(vii) of this section:

(i) An affiliated dual resident corporation or affiliated domestic owner becomes an unaffiliated domestic corporation or a member of a new consolidated group;

(ii) An unaffiliated dual resident corporation or unaffiliated domestic owner becomes a member of a consolidated group;

(iii) Assets of a dual resident corporation or a separate unit are acquired by an unaffiliated domestic corporation or a member of a new consolidated group; or

(iv) A domestic owner of a separate unit transfers its interest in the separate unit to an unaffiliated domestic corporation or to a member of a new consolidated group.

(2) If all of the following requirements are satisfied, the events listed in paragraph (g)(2)(iv)(B)(1) of this section shall not constitute triggering events requiring recapture under paragraph (g)(2)(vii) of this section.

(i) The consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner that filed the agreement under this paragraph (g)(2) and the unaffiliated domestic corporation or new consolidated group must enter into a closing agreement with the Internal Revenue Service providing

that the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner and the unaffiliated domestic corporation or new consolidated group will be jointly and severally liable for the total amount of the recapture of dual consolidated loss and interest charge required in paragraph (g)(2)(vii) of this section, if there is a triggering event described in paragraph (g)(2)(iii) of this section;

(ii) The unaffiliated domestic corporation or new consolidated group must agree to treat any potential recapture amount under paragraph (g)(2)(vii) of this section as unrealized built-in gain for purposes of section 384(a), subject to any applicable exceptions thereunder;

(iii) The unaffiliated domestic corporation or new consolidated group must file an agreement described in paragraph (g)(2)(i) of this section with its timely filed income tax return for the taxable year in which the event described in paragraph (g)(2)(iv)(B)(I) of this section occurs. The agreement must be signed under penalties of perjury by the person who signs the tax return of the unaffiliated domestic corporation or new consolidated group.

(C) *Subsequent triggering events.* Any triggering event described in paragraph (g)(2)(iii) of this section that occurs subsequent to one of the transactions described in paragraph (g)(2)(iv) (A) or (B) of this section and does not fall within the exceptions provided in paragraph (g)(2)(iv) (A) or (B) of this section shall require recapture under paragraph (g)(2)(vii) of this section.

(v) *Ordering rules for determining the foreign use of losses.* If the laws of a foreign country provide for the use of losses of a dual resident corporation to offset the income of another person but do not provide applicable rules for determining the order in which such losses are used to offset the income of another person in a taxable year, then for purposes of this section, the following rules shall govern:

(A) If under the laws of the foreign country the dual resident corporation has losses from different taxable years, the dual resident corporation shall be deemed to use first the losses from the earliest taxable year from which a loss

may be carried forward or back for foreign law purposes.

(B) Any net loss, or income, that the dual resident corporation has in a taxable year shall first be used to offset net income, or loss, recognized by affiliates of the dual resident corporation in the same taxable year before any carryover of the dual resident corporation's losses is considered to be used to offset any income from the taxable year.

(C) Where different losses, expenses, or deductions (*e.g.*, capital losses and ordinary losses) of a dual resident corporation incurred in the same taxable year are available to offset the income of another person, the different losses shall be deemed to offset such income on a pro rata basis.

EXAMPLE. DRC, a domestic corporation, is taxed as a resident under the tax laws of Country Y. Therefore, DRC is a dual resident corporation. FA is a Country Y affiliate of DRC. Country Y's tax laws permit affiliated corporations to file a form of consolidated return. In Year 1, DRC incurs a capital loss of \$80 which, for Country Y purposes, offsets completely \$30 of capital gain recognized by FA. Neither corporation has any other taxable income or loss for the year. In Year 1 (and in other years), DRC recognizes the same amount of income for U.S. purposes as it does for Country Y purposes. Under paragraph (d)(1)(i) of this section, however, DRC's \$80 capital loss is not a dual consolidated loss. In Year 2, DRC incurs a net operating loss of \$100, while FA incurs a net operating loss of \$50. DRC's \$100 loss is a dual consolidated loss. Since the dual consolidated loss is not used to offset the income of another person under Country Y law, DRC is permitted to file an agreement described in this paragraph (g)(2). In Year 3, DRC has a net operating loss of \$10 and FA has capital gains of \$60. For Country Y purposes, DRC's \$10 net operating loss is used to offset \$10 of FA's \$60 capital gain. DRC's \$10 loss is a dual consolidated loss. Because the loss is used to offset FA's income, DRC will not be able to file an agreement under this paragraph (g)(2) with respect to the loss. Country Y permits FA's remaining \$50 of Year 3 income to be offset by carryover losses. However, Country Y has no applicable rules for determining which carryover losses from Years 1 and 2 are used to offset such income. Under the ordering rules of paragraph (g)(2)(v)(A) of this section, none of DRC's \$100 Year 2 loss will be deemed to offset FA's remaining \$50 of Year 3 income. Instead, the \$50 of capital loss carryover from Year 1 will be considered to offset the income.

(vi) *Reporting requirements*—(A) *In general.* The consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must answer the applicable questions regarding dual consolidated losses on its U.S. income tax return filed for the year in which the dual consolidated loss is incurred and for each of the following fifteen taxable years.

(B) *Annual certification.* Except as provided in paragraph (g)(2)(vi)(C) of this section, until and unless Form 1120 (or the Schedules thereto) contains questions pertaining to dual consolidated losses, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must file with its income tax return for each of the fifteen taxable years following the taxable year in which the dual consolidated loss is incurred a certification that the losses, expenses, or deductions that make up the dual consolidated loss have not been used to offset the income of another person under the tax laws of a foreign country. The annual certification must be signed under penalties of perjury by a person authorized to sign the agreement described in paragraph (g)(2)(i) of this section. The certification must identify the dual consolidated loss to which it pertains by setting forth the taxpayer's year in which the loss was incurred and the amount of such loss. In addition, the certification must warrant that arrangements have been made to ensure that the loss will not be used to offset the income of another person under the laws of a foreign country and that the taxpayer will be informed of any such foreign use of any portion of the loss. If dual consolidated losses of more than one taxable year are subject to the rules of this paragraph (g)(2)(vi)(B), the certifications for those years may be combined in a single document but each dual consolidated loss must be separately identified.

(C) *Exception.* A consolidated group or unaffiliated domestic owner is not required to file annual certifications under paragraph (g)(2)(vi)(B) of this section with respect to a dual consolidated loss of any separate unit other than a hybrid entity separate unit.

(vii) *Recapture of loss and interest charge*—(A) *Presumptive rule*—(1) *Amount of recapture.* Except as otherwise provided in this paragraph (g)(2)(vii), upon the occurrence of a triggering event described in paragraph (g)(2)(iii) of this section, the taxpayer shall recapture and report as gross income the total amount of the dual consolidated loss to which the triggering event applies on its income tax return for the taxable year in which the triggering event occurs (or, when the triggering event is a use of the loss for foreign tax purposes, the taxable year that includes the last day of the foreign tax year during which such use occurs).

(2) *Interest charge.* In connection with the recapture, the taxpayer shall pay an interest charge. Except as otherwise provided in this paragraph (g)(2)(vii), such interest shall be determined under the rules of section 6601(a) as if the additional tax owed as a result of the recapture had accrued and been due and owing for the taxable year in which the losses, expenses, or deductions taken into account in computing the dual consolidated loss gave rise to a tax benefit for U.S. income tax purposes. For purposes of this paragraph (g)(2)(vii)(A)(2), a tax benefit shall be considered to have arisen in a taxable year in which such losses, expenses or deductions reduced U.S. taxable income.

(B) *Rebuttal of presumptive rule*—(1) *Amount of recapture.* The amount of dual consolidated loss that must be recaptured under this paragraph (g)(2)(vii) may be reduced if the taxpayer demonstrates, to the satisfaction of the Commissioner, the offset permitted by this paragraph (g)(2)(vii)(B). The reduction in the amount of recapture is the amount by which the dual consolidated loss would have offset other taxable income reported on a timely filed U.S. income tax return for any taxable year up to and including the year of the triggering event if such loss had been subject to the restrictions of paragraph (b) of this section (and therefore had been subject to the separate return limitation year restrictions of §§ 1.1502-21A(c) or 1.1502-21(c) (as appropriate) commencing in the

taxable year in which the loss was incurred. A taxpayer utilizing this rebuttal rule must attach to its timely filed U.S. income tax return a separate accounting showing that the income for each year that offsets the dual resident corporation's or separate unit's recapture amount is attributable only to the dual resident corporation or separate unit.

(2) *Interest charge.* The interest charge imposed under this paragraph (g)(2)(vii) may be appropriately reduced if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the net interest owed would have been less than that provided in paragraph (g)(2)(vii)(A)(2) of this section if the taxpayer had filed an amended return for the year in which the loss was incurred, and for any other affected years up to and including the year of recapture, treating the dual consolidated loss as a loss subject to the restrictions of paragraph (b) of this section (and therefore subject to the separate return limitation year restrictions of §§ 1.1502-21A(c) or 1.1502-21(c) (as appropriate)). A taxpayer utilizing this rebuttal rule must attach to its timely filed U.S. income tax return a computation demonstrating the reduction in the net interest owed as a result of treating the dual consolidated loss as a loss subject to the restrictions of paragraph (b) of this section.

(C) *Computation of taxable income in year of recapture—(1) Presumptive rule.* Except as otherwise provided in paragraph (g)(2)(vii)(C)(2) of this section, for purposes of computing the taxable income for the year of recapture, no current, carryover or carryback losses of the dual resident corporation or separate unit, of other members of the consolidated group, or of the domestic owner that are not attributable to the separate unit, may offset and absorb the recapture amount.

(2) *Rebuttal of presumptive rule.* The recapture amount included in gross income may be offset and absorbed by that portion of the taxpayer's (consolidated or separate) net operating loss carryover that is attributable to the dual consolidated loss being recaptured, if the taxpayer demonstrates, to the satisfaction of the Commissioner, the amount of such portion of the car-

ryover. A taxpayer utilizing this rebuttal rule must attach to its timely filed U.S. income tax return a computation demonstrating the amount of net operating loss carryover that, under this paragraph (g)(2)(vii)(C)(2), may absorb the recapture amount included in gross income.

(D) *Character and source of recapture income.* The amount recaptured under this paragraph (g)(2)(vii) shall be treated as ordinary income in the year of recapture. The amount recaptured shall be treated as income having the same source and falling within the same separate category for purposes of section 904 as the dual consolidated loss being recaptured.

(E) *Reconstituted net operating loss.* Commencing in the taxable year immediately following the year in which the dual consolidated loss is recaptured, the dual resident corporation or separate unit shall be treated as having a net operating loss in an amount equal to the amount actually recaptured under paragraph (g)(2)(vii) (A) or (B) of this section. This reconstituted net operating loss shall be subject to the restrictions of paragraph (b) of this section (and therefore, the separate return limitation year restrictions of §§ 1.1502-21A(c) or 1.1502-21T(c) (as appropriate)). The net operating loss shall be available only for carryover, under section 172(b), to taxable years following the taxable year of recapture. For purposes of determining the remaining carryover period, the loss shall be treated as if it had been recognized in the taxable year in which the dual consolidated loss that is the basis of the recapture amount was incurred.

(F) *Consequences of failing to comply with recapture provisions—(1) In general.* If the taxpayer fails to comply with the recapture provisions of this paragraph (g)(2)(vii) upon the occurrence of a triggering event, then the dual resident corporation or separate unit that incurred the dual consolidated loss (or a successor-in-interest) shall not be eligible for the relief provided in paragraph (g)(2) of this section with respect to any dual consolidated losses incurred in the five taxable years beginning with the taxable year in which recapture is required.

(2) *Exceptions.* In the case of a triggering event other than a use of the losses, expenses, or deductions taken into account in computing the dual consolidated loss to offset income of another person under the income tax laws of a foreign country, this rule shall not apply in the following circumstances:

(i) The failure to recapture is due to reasonable cause; or

(ii) A taxpayer seeking to rebut the presumption of a triggering event satisfies the filing requirements of paragraph (g)(2)(iii)(B) of this section.

(G) *Examples.* The following examples illustrate this paragraph (g)(2)(vii).

EXAMPLE 1. P, a domestic corporation, files a consolidated return with DRC, a dual resident corporation. In Year 1, DRC incurs a dual consolidated loss of \$100 and P earns \$100. P files an agreement under this paragraph (g)(2). Therefore, the consolidated group is permitted to offset P's \$100 of income with DRC's \$100 loss. In Year 2, DRC earns \$30, which is completely offset by a \$30 net operating loss incurred by P. In Year 3, DRC earns income of \$25 while P recognizes no income or loss. In addition, there is a triggering event in Year 3. Therefore, under the presumptive rule of paragraph (g)(2)(vii)(A) of this section, DRC must recapture \$100. However, the \$100 recapture amount may be reduced by \$25 (the amount by which the dual consolidated loss would have offset other taxable income if it had been subject to the separate return limitation year restrictions from Year 1) upon adequate documentation of such offset under paragraph (g)(2)(vii)(B)(1) of this section. Commencing in Year 4, the \$100 (or \$75) recapture amount is treated as a loss incurred by DRC in a separate return limitation year, subject to the restrictions of §§ 1.1502-21A(c) or 1.1502-21(c), as appropriate. The carryover period of the loss, for purposes of section 172(b), will start from Year 1, when the dual consolidated loss was incurred.

EXAMPLE 2. The facts are the same as in EXAMPLE 1, except that in Year 2, DRC earns \$75 and P earns \$50. In Year 3, DRC earns \$25 while P earns \$30. A triggering event occurs in Year 3. The \$100 presumptive amount of recapture can be reduced to zero by the \$75 and \$25 earned by DRC in Years 2 and 3, respectively, upon adequate documentation of such offset under paragraph (g)(2)(vii)(B)(1) of this section. Nevertheless, an interest charge will be owed. Under the presumptive rule of paragraph (g)(2)(vii)(A)(2) of this section, interest will be charged on the additional tax owed on the \$100 of recapture income as if the tax had accrued in Year 1 (the year in which the dual consolidated loss re-

duced the income of P). However, the net interest will be reduced to the amount that would have been owed if the consolidated group had filed amended returns, treating the dual consolidated loss as a loss subject to the separate return limitation year restrictions of § 1.1502-21A(c) or 1.1502-21(c), as appropriate, upon adequate documentation of such reduction of interest under paragraph (g)(2)(vii)(B)(2) of this section.

EXAMPLE 3. P, a domestic corporation, owns DRC, a domestic corporation that is subject to the income tax laws of Country Z on a residence basis. DRC owns FE, a Country Z corporation. In Year 1, DRC incurs a net operating loss for U.S. tax purposes. Under the tax laws of Country Z, the loss is not recognized until Year 3. The Year 1 net operating loss is a dual consolidated loss under paragraph (c)(5) of this section. The consolidated group elects relief under paragraph (g)(2) of this section by filing the appropriate agreement and uses the dual consolidated loss on its U.S. income tax return. In Year 3, the dual consolidated loss is used under the laws of Country Z to offset the income of FE, which is a triggering event under paragraph (g)(2)(iii) of this section. However, the consolidated group does not recapture the dual consolidated loss. The consolidated group's failure to comply with the recapture provisions of this paragraph (g)(2)(vii) prevents DRC from being eligible for the relief provided under paragraph (g)(2) of this section for any dual consolidated losses incurred in Years 3 through 7, inclusive.

(h) *Effective date—(1) In general.* These regulations are effective for taxable years beginning on or after October 1, 1992. Section 1.1503-2A is effective for taxable years beginning after December 31, 1986, and before October 1, 1992.

(2) *Taxpayers that have filed for relief under § 1.1503-2A—(i) In general.* Except as provided in paragraph (h)(ii)(b) of this section, taxpayers that have filed agreements described in § 1.1503-2A(c)(3) or certifications described in § 1.1503-2A(d)(3) shall continue to be subject to the provisions of such agreements or certifications, including the amended return or recapture requirements applicable in the event of a triggering event, for the remaining term of such agreements or certifications.

(ii) *Special transition rule.* A taxpayer that has filed an agreement described in § 1.1503-2A(c)(3) or a certification described in § 1.1503-2A(d)(3) and that is in compliance with the provisions of § 1.1503-2A may elect to replace such agreement or certification with an

agreement described in paragraph (g)(2)(i) of this section. However, a taxpayer making this election must replace all agreements and certifications filed under §1.1503-2A. If the taxpayer is a consolidated group, the election must be made with respect to all dual resident corporations or separate units within the group. Likewise, if the taxpayer is an unaffiliated domestic owner, the election must be made with respect to all separate units of the domestic owner. The taxpayer must file the replacement agreement with its timely filed income tax return for its first taxable year commencing on or after October 1, 1992, stating that such agreement is a replacement for the agreement filed under §1.1503-2A(c)(3) or the certification filed under §1.1503-2A(d)(3) and identifying the taxable year for which the original agreement or certification was filed. A single agreement described in paragraph (g)(2)(i) of this section may be filed to replace more than one agreement or certification filed under §1.1503-2A; however, each dual consolidated loss must be separately identified. A taxpayer may also elect to apply §1.1503-2 for all open years, with respect to agreements filed under §1.1503-2A(c)(3) or certifications filed under §1.1503-2A(d)(3), in cases where the agreement or certification is no longer in effect and the taxpayer has complied with the provisions of §1.1503-2A. For example, a taxpayer may have had a triggering event under §1.1503-2A that is not a triggering event under §1.1503-2. If the taxpayer fully complied with the requirements of the agreement entered into under §1.1503-2A(c)(3) and filed amended U.S. income tax returns within the time required under §1.1503-2A(c)(3), the taxpayer may file amended U.S. income tax returns consistent with the position that the earlier triggering event is no longer a triggering event.

(3) *Taxpayers that are in compliance with §1.1503-2A but have not filed for relief thereunder.* A taxpayer that is in compliance with the provisions of §1.1503-2A but has not filed an agreement described in §1.1503-2A(c)(3) or a certification described in §1.1503-2A(d)(3) may elect to have the provisions of §1.1503-2 apply for any open

year. In particular, a taxpayer may elect to apply the provisions of §1.1503-2 in a case where the dual consolidated loss has been subjected to the separate return limitation year restrictions of §1.1502-21A(c) or 1.1502-21(c) (as appropriate) but the losses, expenses, or deductions taken into account in computing the dual consolidated loss have not been used to offset the income of another person for foreign tax purposes. However, if a taxpayer is a consolidated group, the election must be made with respect to all dual resident corporations or separate units within the group. Likewise, if the taxpayer is an unaffiliated domestic owner, the election must be made with respect to all separate units of the domestic owner.

[T.D. 8434, 57 FR 41084, Sept. 9, 1992; 57 FR 48722, Oct. 28, 1992; 57 FR 57280, Dec. 3, 1992; 58 FR 13413, Mar. 11, 1993, as amended by T.D. 8597, 60 FR 36680, July 18, 1995; T.D. 8677, 61 FR 33325, June 27, 1996; T.D. 8823, 64 FR 36101, July 2, 1999]

§ 1.1504-0 Outline of provisions.

In order to facilitate the use of §§1.1504-1 through 1.1504-4, this section lists the captions contained in §§1.1504-1 through 1.1504-4.

§ 1.1504-1 *Definitions.*

§ 1.1504-2 *[Reserved]*

§ 1.1504-3 *[Reserved]*

§ 1.1504-4 *Treatment of warrants, options, convertible obligations, and other similar interests.*

- (a) Introduction.
 - (1) General rule.
 - (2) Exceptions.
 - (b) Options not treated as stock or as exercised.
 - (1) General rule.
 - (2) Options treated as exercised.
 - (i) In general.
 - (ii) Aggregation of options.
 - (iii) Effect of treating option as exercised.
 - (A) In general.
 - (B) Cash settlement options, phantom stock, stock appreciation rights, or similar interests.
 - (iv) Valuation.
 - (3) Example.
 - (c) Definitions.
 - (1) Issuing corporation.
 - (2) Related or sequential option.
 - (3) Related persons.
 - (4) Measurement date.
 - (i) General rule.
 - (ii) Issuances, transfers, or adjustments not treated as measurement dates.